

CHAPTER 1

INTRODUCTION

Objectives

Upon completion of this workshop, you will be able to:

- Articulate the main difference between "nonprofit" organizations and "tax-exempt" organizations
 - List several of the types of organizations qualifying for 501(c)(3) "public charity" status
 - Explain the activities that 501(c)(3) organizations should avoid or limit to protect their exempt status
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Please Note

This material is for educational use only, in association with the Exempt Organizations (EO) Workshop. It is not intended to establish IRS positions and may not be relied upon or cited as precedent.

For More Information

This text primarily focuses on requirements for 501(c)(3) organizations. Some basic information is presented about organizations exempt under other code sections as well. For a more detailed discussion, including exceptions to the general information provided in this text, please refer to the publications and sections of law cited in the material. Each chapter of this text contains a complete list of references.

Legal Authority

The IRC is Title 26 of the U.S. Code. Congress codified the IRC in 1939. It was comprehensively updated in 1954 and 1986. The tax laws have been amended many times by Congress and interpreted by the courts, and the resulting body of law guides all U.S. tax administration.

Treasury and the IRS issue regulations that set forth their interpretation of the law. The regulations are signed and issued by the Secretary of the Treasury (or his delegate) under Title 26. The regulations carry more weight than any rulings or releases on tax matters otherwise issued by the IRS or Treasury.

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INTRODUCTION, continued

**Internal
Revenue Code
(IRC) Citations**

All section references are to the IRC unless otherwise stated. For example, section 501(c)(3) refers to IRC section 501(c)(3). The IRC is also sometimes referred to as “the Code.”

**Forms and
Publications**

You may order forms and publications by calling (800) 829-3676, or by downloading them from www.irs.gov/formspubs/.

CHAPTER 2

TAX-EXEMPT STATUS

**Types of
Exempt
Organizations**

The IRC specifies certain types of organizations that are exempt from federal income tax. The most common types are charitable, religious and educational organizations, civic associations, labor organizations, business leagues, social clubs, fraternal organizations, and veterans' organizations.

Although the focus of this text is on organizations exempt under section 501(c)(3), commonly referred to as charities or charitable organizations, general information will be presented about organizations exempt under other Code sections as well.

**Obtaining
Exempt Status**

Not all non-profit organizations are tax-exempt under federal law. To be tax exempt, the organization must be described in section 501(c) and apply for recognition of exemption by filing either Form 1023 for exempt status under 501(c)(3) or Form 1024 for exempt status under another subsection of 501(c). If the IRS approves the application, it will issue a "determination letter" indicating the code section under which the organization is exempt from federal income tax.

**Who Can Be
Tax-Exempt?**

Section 501(c) enumerates many different kinds of organizations that qualify for exempt status. The Organization Reference Chart at the end of this chapter (Exhibit A) lists the various subsections under which an organization could qualify for tax-exempt status, and under each subsection:

- A brief description of the type of organization that may qualify
 - The general nature of its activities
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TAX-EXEMPT STATUS, Continued

Common Types of Exempt Organizations

Some of the more common types of exempt organizations are defined in the following Code sections:

- 501(c)(3) Religious, Educational, Charitable
 - 501(c)(4) Civic Leagues, Social Welfare Organizations
 - 501(c)(5) Labor, Agricultural, or Horticultural
 - 501(c)(6) Business Leagues, Chambers of Commerce
 - 501(c)(7) Social and Recreational Clubs
 - 501(c)(8) Fraternal Beneficiary Societies and Associations
 - 501(c)(10) Domestic Fraternal Societies and Associations
 - 501(c)(19) Veterans' Organizations
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Benefits of Exempt Status

The main benefit of exempt status is that the organization does not pay federal income tax on income related to its exempt purpose. Other benefits include:

- (1) Possible exemption from certain employment, state income, sales and property taxes, and
- (2) Reduced postal rates offered to certain organizations by the U.S. Postal Service.

If an organization is not recognized as tax-exempt, it must file one of the following annual income tax returns:

- Form 1120, *U.S. Corporation Income Tax Return*
 - Form 1041, *U.S. Income Tax Return for Estates and Trusts*
 - Form 1065, *U.S. Partnership Return of Income*
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TAX-EXEMPT STATUS, Continued

Deductible Contributions to Organizations Exempt Under 501(c)(3)

Contributions to 501(c)(3) organizations are deductible on the donor's federal income tax return if the donor chooses to itemize deductions. Contributions to most other types of tax-exempt organizations do not qualify for a deduction.

501(c)(3) Organizations: Requirements

501(c)(3) organizations comprise the largest category of exempt organizations. There are two requirements for exemption under section 501(c)(3). The organization must be:

- (1) *Organized*, and
 - (2) *Operated* exclusively for one or more exempt purposes.
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Requirement 1: Organized

A 501(c)(3) organization must be *organized* as a nonprofit corporation, trust, or unincorporated association. In addition, its organizing documents (articles of incorporation, trust documents, articles of association, etc.) must:

- Limit its purpose(s) to those described in section 501(c)(3)
 - Align its activities with its exempt purposes
 - Dedicate its assets only to exempt purposes
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TAX-EXEMPT STATUS, Continued

**Requirement 2:
Operated** Because a 501(c)(3) organization must engage exclusively in activities that accomplish its exempt purpose(s), other activities are prohibited or restricted.

A 501(c)(3) organization cannot:

- Participate in political campaigns on behalf of, or in opposition to, any candidate for public office
 - Perform lobbying activities as a substantial part of its overall activities
 - Allow its earnings to inure to the benefit of any private shareholder or individual
 - Operate for the benefit of private interests such as those of its founder, the founder's family, its shareholders, or persons controlled by such interests
 - Operate for the primary purpose of conducting a trade or business that is not related to its exempt purpose
 - Perform activities that are illegal or that violate fundamental public policy.
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**Exempt
Purpose**

An organization must state one or more exempt purposes in its organizing document. Section 501(c)(3) lists the following exempt purposes:

- Charitable
 - Educational
 - Religious
 - Scientific
 - Literary
 - Fostering national or international amateur sports competition
 - Preventing cruelty to children or animals
 - Testing for public safety
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TAX-EXEMPT STATUS, Continued

Typical 501(c)(3) Organizations

The most common types of 501(c)(3) organizations are charitable, educational, or religious.

Charitable Organizations

Charitable organizations conduct activities that promote any of the following purposes:

- Relief of the poor, the distressed, or the underprivileged
 - Advancement of religion
 - Advancement of education or science
 - Building or maintaining public buildings, monuments, or works
 - Lessening the burdens of government
 - Reducing neighborhood tensions
 - Helping eliminate prejudice and discrimination
 - Defending human and civil rights
 - Combating community deterioration and juvenile delinquency
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TAX-EXEMPT STATUS, Continued

Educational Organizations

Educational organizations include:

- Primary or secondary schools, colleges or professional or trade schools that have a regularly scheduled curriculum, faculty, and enrolled body of students
 - Organizations that conduct public discussion groups, forums, panels, lectures, or other similar programs
 - Organizations that present a course of instruction by means of correspondence or through the use of electronic devices, means, or services.
 - Museums, zoos, planetariums, symphony orchestras, or similar organizations
 - Non-profit day-care centers
 - Youth sports organizations
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Religious Organizations

While all churches are religious organizations, not all religious organizations are churches.

Churches: The term church includes synagogues, temples, mosques and similar types of organizations. Churches are not required to file an application for exemption. Nevertheless, many churches do file voluntarily to obtain an IRS determination letter. The letter assures contributors that the church is tax-exempt under section 501(c)(3). To be recognized as a church, an organization must meet certain criteria. These criteria are outlined in Publication 1828, *Tax Guide for Churches and Religious Organizations*. Exempt churches are not required to file an annual Form 990 (see Chapter 8 for details).

Other Religious Organizations: Other religious organizations (*e.g.*, mission organizations, speakers' organizations, nondenominational ministries, ecumenical organizations and faith-based social services agencies) that do not meet the criteria of a church must apply for tax-exempt status on Form 1023.

TAX-EXEMPT STATUS, Continued

Public Charity or Private Foundation

Every organization that qualifies as tax exempt under section 501(c)(3) is classified as either a *public charity* or a *private foundation*. Under section 508, every organization is automatically classified as a private foundation, except churches, certain educational organizations and certain trusts, unless it meets the criteria of a public charity listed in section 509(a).

The primary distinction between a public charity and a private foundation lies in the source of financial support. A public charity typically has a broad base of public support whereas a private foundation generally is supported by just a few individuals, such as members of a family.

Whether a 501(c)(3) organization is classified as a public charity or private foundation is important because different tax rules apply to each. For example, the deductibility of contributions to a private foundation is more limited than the deductibility of contributions to a public charity. In addition, private foundations are subject to stricter federal regulation and may be subject to excise taxes not imposed on public charities.

Important



Fact

New Idea



TAX-EXEMPT STATUS, Continued

Public Charities

Organizations meeting the definition of public charity under section 509(a) include:

- Churches
- Schools
- Organizations that provide medical or hospital care (including the provision of medical education and, in certain cases, medical research)
- Organizations that receive a substantial part of their support in the form of contributions from publicly supported organizations, governmental units and/or from the general public
- Organizations that normally receive not more than one-third of their support from gross investment income and after-tax UBI and more than one-third of their support from gifts, grants, contributions, or membership fees and gross receipts from activities related to their exempt functions
- Organizations that support one or more of the organizations described above and have a governance relationship with those organizations (supporting organizations)
- Organizations that are organized and operated exclusively for testing for public safety

To be classified as a public charity solely on the basis of public support, an organization must meet one of the tests set out in the regulations. An organization's level of public support is calculated on the basis of a 5-year moving average, which includes the current tax year and the 4 years preceding the current year.

Such organizations must continuously seek significant and diversified public support and should carefully monitor their public support calculations to avoid losing their public charity status.

TAX-EXEMPT STATUS, Continued

Initial Determination of Public Support Status

A new 501(c)(3) organization will be classified as a public charity for its first 5 years if the organization shows it can reasonably expect to be publicly supported, regardless of the public support actually received during that 5-year period.

The IRS will monitor an organization's public charity status after the first 5 years based on the public support information reported annually by the organization. Beginning with the organization's sixth year – and for all following years – if an organization shows it meets a public support test, it will remain a public charity for that year and the next tax year.

Example: Determination of Public Support

If a calendar year organization meets the public support test for the 2011 tax year, the organization is considered to be a public charity for the 2011 and 2012 tax years. If the organization does not meet the support test for the 2012 tax year, it will still be considered to be a public charity for that year because of the carryover from 2011.

However, if the organization cannot meet the public support test for the 2013 tax year, it will be reclassified as a private foundation starting at the beginning of the 2013 tax year, and should file Form 990-PF, *Return of Private Foundation*, for the 2013 tax year and for all future years.

Other Common Types of Exempt Organizations

There are many types of exempt organizations other than 501(c)(3). The following paragraphs contain descriptions of other common types of exempt organizations.

TAX-EXEMPT STATUS, Continued

501(c)(4) - Civic Leagues, Social Welfare Organizations

Organizations exempt under section 501(c)(4) must be organized exclusively for the promotion of social welfare. A 501(c)(4) organization operates primarily to further the common good and the general welfare of the people of the community, such as by bringing about civic betterment and social improvements. Section 501(c)(4) organizations also include groups formed to educate and inform the public about particular issues.

Examples of 501(c)(4) organizations include volunteer fire companies, civic leagues, and community associations.

Although 501(c)(4) organizations often conduct activities similar to those of 501(c)(3) organizations, they are not constrained by many of the restrictions and prohibitions placed on (c)(3)s. On the other hand, contributions to 501(c)(4) organizations are not deductible for the donor.

501(c)(5) - Labor, Agricultural and Horticultural Organizations

Organizations exempt under section 501(c)(5) exist to better the conditions of workers, improve products, or develop a greater degree of efficiency in particular occupations.

A labor organization is an association of workers combined to protect or promote members' interests by bargaining collectively with their employer to secure better working conditions, wages, and similar benefits. The term includes labor unions, councils, and committees.

Agricultural and horticultural organizations are involved in raising livestock, forestry, cultivating land, raising and harvesting crops or aquatic resources, cultivating useful or ornamental plants, and similar pursuits.

501(c)(6) - Business Leagues, Chambers of Commerce, etc.

Organizations exempt under section 501(c)(6) are associations of people with common business interests whose purpose is to promote those interests. It is not to engage in a regular business for profit. Their activities are devoted to the improvement of business conditions in one or more lines of business rather than the performance of particular services for individual persons.

Examples of 501(c)(6) organizations are business leagues, chambers of commerce, real estate boards, and boards of trade.

TAX-EXEMPT STATUS, Continued

501(c)(7) - Social and Recreation Clubs

A social club exempt under section 501(c)(7) is organized for pleasure, recreation, and other similar non-profit purposes. Substantially all of its activities are devoted to those purposes. This section encompasses clubs supported by membership fees, dues and assessments, as well as fees charged to members for the use of facilities.

Typical organizations under this section include:

- College alumni associations that do not qualify as educational organizations
- College fraternities or sororities operating chapter houses for students
- Country clubs
- Amateur hunting, fishing, tennis, swimming, and other sport clubs
- Dinner clubs that provide a meeting place and dining room for members
- Hobby clubs
- Garden clubs
- Variety clubs

A club that engages primarily in a business activity open to the general public will not qualify for this exemption. In addition, exemption will be denied to any club with a written policy of discrimination against any person on the basis of race, color, or religion.

TAX-EXEMPT STATUS, Continued

501(c)(8) - Fraternal Beneficiary Societies and Associations

A fraternal beneficiary society, order or association under 501(c)(8) must:

- Have a fraternal purpose
- Be operated under a “lodge system” consisting of local branches chartered by a parent organization for the exclusive benefit of the members
- Provide for the payment of life, sick, accident or other insurance benefits to the members of the society, order or association or their dependents

The organization may qualify for exemption as long as the majority (i.e., not all) of the members are eligible for benefits.

501(c)(10) - Domestic Fraternal Societies and Associations

Section 501(c)(10) domestic fraternal societies and associations are similar to (c)(8) fraternal beneficiary societies except that they may not provide insurance benefits to members. Domestic fraternal societies must also devote their net earnings exclusively to religious, charitable, scientific, literary, educational, or fraternal purposes. College fraternities are not eligible for exemption under section 501(c)(10), but may be eligible under section 501(c)(7).

501(c)(19) - Veterans’ Organization

A section 501(c)(19) veterans’ organization is a post or organization located in the United States of past or present members of the U.S. military, or an auxiliary unit of such a post or organization. An organization does not qualify for exemption under section 501(c)(19) unless at least 75 percent of its members are past or present members of the U.S. military. Substantially all of the other members must be cadets or spouses, widows, widowers, ancestors, or lineal descendants of past or present members of the armed forces or of cadets.

Veterans’ organizations must be operated exclusively to promote the social welfare of the community, to assist disabled and needy war veterans and their dependents, or to provide entertainment or care to hospitalized veterans. They may also carry on programs to perpetuate the memory of veterans; conduct programs for religious, charitable, scientific, literary, or educational purposes; sponsor patriotic activities; provide insurance benefits to members or their dependents; or provide social and recreational activities to members.

TAX-EXEMPT STATUS, Continued

Contributions to These Other Common Types of Exempt Organizations

Contributions to organizations exempt under sections 501(c)(4), (5), (6), (7), (8), (10), and (19) are generally not tax-deductible. A contribution to a veterans' organization is deductible only if at least 90 percent of the organization's members served in the U.S. armed forces during a period of war and substantially all of the other members are either veterans, cadets, or spouses, widows or widowers of war veterans, veterans, or cadets. A contribution to a domestic fraternal society, order, or association operating under the lodge system is deductible only if it is used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

For More Information

- Publication 526, *Charitable Contributions*
 - Publication 557, *Tax-Exempt Status for Your Organization*
 - Publication 1828, *Tax Guide for Churches and Religious Organizations*
 - Publication 3386, *Tax Guide – Veterans' Organizations*
 - Publication 3833, *Disaster Relief – Providing Assistance Through Charitable Organizations*
 - Publication 4220, *Applying for 501(c)(3) Tax-Exempt Status*
 - Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*
 - Form 1024, *Application for Recognition of Exemption Under Section 501(a)* (for organizations described in sections 501(c)(2), (4), (5), (6), (7), (8), (9), (10), (12), (13), (15), (17), (19), and (25))
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Forms and Publications

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Organization Reference Chart		
Section of 1986 Code	Description of organization	General nature of activities
501(c)(1)	Corporations Organized Under Act of Congress (including Federal Credit Unions)	Instrumentalities of the United States
501(c)(2)	Title Holding Corporation for Exempt Organization	Holding title to property of an exempt organization
501(c)(3)	Religious, Educational, Charitable, Scientific, Literary, Testing for Public Safety, Fostering National or International Amateur Sports Competition, or the Prevention of Cruelty to Children or Animals	Activities of a nature implied by the description of the class of organization
501(c)(4)	Civic Leagues, Social Welfare Organizations, and Local Associations of Employees	Promotion of social welfare; charitable, educational, or recreational
501(c)(5)	Labor, Agricultural, and Horticultural Organizations	Educational or instructive, the purpose being to improve conditions of work and to improve products and efficiency
501(c)(6)	Business Leagues, Chambers of Commerce, Real Estate Boards, Etc.	Improvement of business conditions of one or more lines of business
501(c)(7)	Social and Recreation Clubs	Pleasure, recreation, social activities
501(c)(8)	Fraternal Beneficiary Societies and Associations	Lodge providing for payment of life, sickness, accident, or other benefits to members and dependants
501(c)(9)	Voluntary Employees' Beneficiary Associations	Providing for payment of life, sickness, accident, or other benefits to members
501(c)(10)	Domestic Fraternal Societies and Associations	Lodge devoting its net earnings to charitable, fraternal, and other specified purposes. No life, sickness, or accident benefits to members
501(c)(11)	Teachers' Retirement Fund Associations	Teachers' association for payment of retirement benefits
501(c)(12)	Benevolent Life Insurance Associations, Mutual Ditch or Irrigation Companies, Mutual or Cooperative Telephone Companies, or similar.	Activities of a mutually beneficial nature similar to those implied by the description of the organization
501(c)(13)	Cemetery Companies	Burials and incidental activities
501(c)(14)	State Chartered Credit Unions, Mutual Reserve Funds	Providing loans to members
501(c)(15)	Mutual Insurance Companies or Associations	Providing insurance to members substantially at cost
501(c)(16)	Cooperative Organizations to Finance Crop Operations	Financing crop operations in conjunction with activities of a marketing or purchasing association
501(c)(17)	Supplemental Unemployment Benefit Trusts	Providing for payment of supplemental unemployment compensation benefits

Organization Reference Chart		
Section of 1986 Code	Description of organization	General nature of activities
501(c)(18)	Employee Funded Pension Trust (created before June 25, 1959)	Payments of benefits under a pension plan funded by employees
501(c)(19)	Post of Organization of Past or Present Members of the Armed Forces	Activities implied by nature of organization
501 (c)(20)	Group Legal Services Plan Organizations	Activities implied by nature of the organization
501(c)(21)	Black Lung Benefit Trusts	Funded by coal mine operators to satisfy their liability for disease or death due to black lung diseases
501(c)(22)	Withdrawal Liability Payment Fund	Providing funds to meet the liability of employers withdrawing from a multi-employer pension fund
501(c)(23)	Veterans Organization (created before 1880)	Providing Insurance and other benefits to veterans
501(c)(25)	Title Holding Companies or Trusts with Multiple Parents	Holding title and paying over income from property to 35 or fewer parents or beneficiaries
501(c)(26)	State-Sponsored Organization Providing Health Coverage for High-Risk Individuals	Providing health care coverage to high-risk individuals
501(c)(27)	State-Sponsored Workers' Compensation Reinsurance Organization	Reimburses members for losses under workers' compensation acts
501(c)(28)	The National Railroad Retirement Investment Trust	The organization established under section 15(j) of the Railroad Retirement Act of 1974
501(c)(29)	Co-op Health Insurance Issuers	Providing health insurance to individuals and small group as part of the CO-OP program
501(d)	Religious and Apostolic Associations	Regular business activities. Communal religious community
501(e)	Cooperative Hospital Service Organizations	Performing cooperative services for hospitals
501(f)	Cooperative Service Organizations of Operating Educational Organizations	Performing collective investment services for education organizations
501(k)	Child Care Organizations	Providing care for children
501(n)	Charitable Risk Pools	Pools certain insurance risks of 501(c)(3) organizations
521(a)	Farmers' Cooperative Associations	Cooperative marketing and purchasing for agricultural producers
527	Political Organizations	A party, committee, fund, association, etc., that directly or indirectly accepts contributions or makes expenditures for political campaigns
529	Qualified Tuition Programs	Established and maintained to allow either prepaying, or contributing to an account established for paying, a student's qualified higher education expenses at an eligible educational institution